SCS Agency
Franchise Tax Board

REVISED ANALYSIS

Author: Alquist | Analyst: Marion Mann DeJong | Bill Number: AB 1218

Related Bills: ______ | Telephone: (916) 845-6979 | Amended Date: 02/26/98

Attorney: Doug Bramhall | Sponsor: ______

SUBJECT: B&CT Deduction/Interest Expense/Insurance Companies

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

_____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO ________________________.

_____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ___________ STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY OF BILL

This bill would allow corporations commercially domiciled in California to deduct interest expense attributable to dividends that are received from an insurance company subsidiary and are excluded from income. This bill would further specify that Section 24425 (which denies a deduction for expenses relating to the production of income that is not included in the measure of California tax) would not apply to expenses related to deductible dividends received from insurance companies. This bill would provide that these changes are declaratory of existing law.

SUMMARY OF REVISION

The analysis is revised to reflect a recent Board of Equalization case, the Appeal of Zenith National Insurance Corporation (Appeal of Zenith), 98-SBE-001, January 8, 1998, which specifically deals with the application of Section 24425 in the context of Section 24410.

EFFECTIVE DATE

As a tax levy this bill would become effective immediately upon enactment and apply to income years beginning on or after January 1, 1998. However, the bill specifies that it is declaratory of existing law and thus would apply to all

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O	____ S ____ O	Position Approved ____
____ SA ____ OUA	____ SA ____ OUA	Position Disapproved ____
____ N ____ NP	____ N ____ NP	Position Noted ____
____ NA ____ NAR	____ NA ____ NAR	
____X____ PENDING	DEFER TO ___________	
Legislative Director Date	Agency Secretary Date	By: Date:
G. Alan Hunter 5/5/98		

income years with open statutes.

BACKGROUND

Insurance companies in California are taxed by levying a flat percentage tax (2.35%) on their gross written premiums, with certain deductions. This tax is imposed under Article XIII, Section 28 of the California Constitution and is intended to be "in lieu of" all other taxes or methods of taxation. Thus, a corporation engaged in the insurance business is not subject to the Bank and Corporation Tax Law and is not included in a unitary group's combined report.

Many insurance companies have adopted a structure in which the parent corporation (which is subject to the Bank and Corporation Tax Law) is a holding company with an insurance company subsidiary. One advantage of this structure is that the parent holding company can borrow and invest where the insurance company subsidiary is prohibited for regulatory reasons.

To prevent double taxation (gross premiums tax on the insurance company subsidiary and taxable dividends to the corporate parent), a dividend exclusion was enacted in the Bank and Corporation Tax Law.

SPECIFIC FINDINGS

Federal law allows a deduction from gross income for dividends received from a domestic corporation that is subject to income tax. This deduction is limited by stock ownership. One hundred percent of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership); 80% of the deduction is allowed when received from a corporation which is and least 20% but less than 80% owned; and 70% of the deduction is allowed when received from a corporation less than 20% owned. The percentage owned refers to the percentage of stock, by vote and value, owned by the recipient corporation. Preferred stock is not considered in determining the percentage of stock owned. In addition, 100% of the deduction is allowed for dividends received by a small business investment company.

The total dividend deduction cannot exceed 70% (80% in the case of a 20% owned corporation) of its recomputed taxable income. When recomputing taxable income, any net operating loss deduction, dividends received deduction, capital loss carryback and certain special deductions are not allowed.

Federal law generally allows a deduction for interest paid or accrued during the income year on a corporation's indebtedness. However, that deduction is disallowed to the extent attributable to the production of exempt income.

Current state law (Section 24402) excludes from taxable income a portion of any dividends received in taxable years beginning after 1989 that are paid out of income that was subject to either the franchise tax, the alternative minimum tax or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporation income at the corporate level. The exclusion is in the form of a deduction from gross income. In order for the recipient corporation to claim such a deduction, the paying corporation must have had income from sources in California that required the filing of a California income or franchise tax return. The Franchise Tax Board (FTB) makes a computation each year, after the returns are filed, to determine the percentage of dividends paid during the year which are deductible by recipient corporations. In making this computation, a formula is used, allocating within and without the state certain items, such as federal income tax, which affect earnings and profits but which do not affect the income taxable for California tax purposes.

Once California deductible dividends have been computed, the deduction is further limited in a manner similar to the federal stock ownership rules. One hundred percent of the computed deduction is allowed when received from a corporation more than 50% owned by the recipient; 80% of the computed deduction is allowed when received from a corporation which is at least 20% but less than 50% owned; and 70% of the computed deduction is allowed when received from a corporation less than 20% owned.

Under current state law (Section 24410), corporations commercially domiciled in California are permitted to deduct dividends received from an insurance company subsidiary operating in California and subject to the gross premiums tax, provided at least 80% of each class of stock of the insurance company is owned by the parent corporation. The deduction is based on the portion of the dividend deemed to be attributable to California sources, determined by applying a special three-factor formula.

Current state law generally provides a deduction for all interest paid or accrued on business debts. However, California restricts interest expense deductions of corporations subject to allocation and apportionment, when their total interest expenses, less expenses deducted in arriving at net nonbusiness income, exceed business (apportionable) interest income. Deductible interest attributable to nonbusiness income includes interest, deductible for federal purposes, incurred for foreign investment, which may be offset against deductible dividends (under Section 24111). The purpose of the "interest offset" is to limit interest expense deductions attributable to the production of nonbusiness income not included in the measure of the California tax.

Current state law (Section 24425) denies a deduction for expenses relating to the production of income that are not included in the measure of California tax.

This bill would allow corporations commercially domiciled in California to deduct interest expense attributable to dividends received from an insurance company subsidiary which are excluded from income (pursuant to the dividends received deduction of Section 24410).

This bill would further specify that Section 24425 would not apply to expenses related to deductible dividends that a corporation commercially domiciled in California received from an insurance company subsidiary.

This bill would provide that these changes are declaratory of existing law.

<u>CURRENT PRACTICE/CASE LAW</u>

Under current practice, the FTB applies Section 24425 to deny a double tax benefit when expenses are attributable to income that was excluded from the measure of tax due to the dividends received deduction.

This position has been supported by significant judicial authority, including <u>Great Western Financial Corp.</u> v <u>Franchise Tax Board</u> (Great Western), (1971) 4

Cal. 3d 1 [92 Cal. Rptr. 489] and the Board of Equalization decision in Appeal of Mission Equities Corporation (Appeal of Mission Equities), Cal. St. Bd. of Equal., January 7, 1975. In both of these cases a parent corporation received dividends from a subsidiary which were deductible. To the extent otherwise deductible expenses, including interest, were allocable to the deductible dividends, the expenses were disallowed under Section 24425 (disallowance of deduction related to items not included in income). Neither of these cases specifically dealt with the application of Section 24425 in the context of Section 24410 (dividends received deduction for an insurance company).

However, in the Appeal of Zenith, the State Board of Equalization, citing the Great Western case, held that Section 24425 applies to Section 24410 dividends. The Board further held that the proper method for determining the amount of interest expense to assign to deductible dividends is direct tracing. If direct tracing cannot be used then a reasonable allocation method should be used. On the facts of the Zenith case, the Board held that for some years the most significant amount of interest at issue was directly traceable to taxable income, and was therefore deductible. For the other year, the Board could not directly trace the interest expense so a reasonable allocation method was used to assign some of the interest expense to the dividend deduction.

Policy Considerations

The provision of this bill would raise the following policy considerations.

- This bill provides that the amendments are declaratory of existing law. However, after this bill was introduced in 1997, the State Board of Equalization, in the Appeal of Zenith, allowed Section 24425 to apply to Section 24410 dividends and provided guidance as to the proper method of assigning interest expense to Section 24410 dividends. Thus, it is arguable that given the Appeal of Zenith, the changes are not declaratory, but a change from, existing law.

- This bill would allow a deduction for expenses attributable to income that is not taxed, providing a double benefit.

Implementation Considerations

Implementation of this bill would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate And Discussion

The bill provides that the proposed changes *are declaratory of existing law*. Effectively, this would resolve any disputed interest deduction limitation issues in favor of taxpayers. As a result, the bill would have no identifiable revenue impact.

However, if this bill were *not declaratory of existing law*, removing the interest deduction limitation for insurance company dividends prospectively (beginning January 1, 1998) and retroactively (for all open years) would result in revenue losses (including interest that would have been received for prior years) estimated as shown below.

Revenue Impact of AB 1218 As Amended February 26, 1998 (In $Millions)			
Fiscal Years	1998-99	1999-00	2000-01
Prior Open Years	($8)	($3)	-
Prospective Basis	($1)	($1)	($1)
Revenue Impact	**($9)**	**($4)**	**($1)**

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

The estimate above is based on available audit information regarding proposed assessments for the relevant interest deduction issue and, in the case of prior open years, includes interest amounts that would have otherwise applied.

BOARD POSITION

Pending.

The Franchise Tax Board voted at its July 21, 1997, meeting to support the June 30, 1997, version of this bill. However, this position was taken prior to the Appeal of Zenith.